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David Lawrence Thorn
Lehigh University

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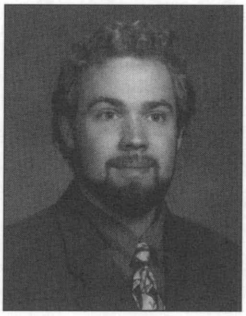


Introduction

In a speech given in October 1999 at the Swiss-American Chamber of Commerce in New York, Hans Meyer, Chairman of the Governing Board of the Swiss National Bank, commented, "It is perhaps a small comfort, but nevertheless important, to point out that we find ourselves in a similar position as our neighbors and other comparable industrial states." (Meyer, "A View...," p. 3) This remark alludes to Switzerland's peculiar geographical, political, and financial situation, the fact that it lies at the very heart of a monetarily unified Europe and, although Switzerland is not a member itself, shares its borders with four of the eleven member countries that currently comprise the European Monetary Union. A consequence of this triplex similarity to its neighbors is that Switzerland has been forced into a new economic environment to which adaptation is a necessity for the future viability of its independence. In this setting Swiss monetary policy decisions must be made with critical consideration given to the policies of the European Central Bank and to the general condition of the euro economy. Indeed, for the past several years the Swiss have been ardently working to bring certain policies more in line with EU policy. Currently, the Swiss have assumed a somewhat liberal yet perpetually vigilant monetary policy stance and are prepared to take reactive measures in the event of any economic turbulence from either within or outside of their borders.

This article will examine both the monetary policies of the Swiss National Bank (SNB) and the European Central Bank (ECB). After a thorough comparison of policy goals, instrumentation, and implementation, the central focus will be to highlight specific instances in which the Swiss have been compelled to conform to the long-term monetary policy stance of the European Central Bank. Past experience, present know-how, and the future prospects of successful and respectable independent survival will prove to be the guiding forces behind Switzerland's voluntary exclusion from one of the largest economic entities in the world.

Past Experience

There currently exists an intricate interrelationship between the economies of Switzerland and the European Union that is fundamentally based on a history of profuse trade between the Swiss and the individual countries of the EU. This arrangement was initiated following the Bretton Woods Conference in 1944 with the liberalization of international commerce throughout the world. Deregulation in many domestic financial markets was a necessary precursor of the existence of free trade. Of singular importance to Switzerland and its role as one of the preeminent financial centers in the world was the eventual dismantling of the barriers against exchangeable capital. Once the notion of convertible currencies gained acceptance, flexible exchange rates became a reality; subsequently goods, services, and capital were finally able to flow freely across borders. (Gehrig, p. 2) In addition to these relaxed international constraints, the overwhelming growth of information technology has also had an enormous impact on international capital markets. ("Recent Trends in Euroland...") Undoubtedly, economic and technological globalization are rapidly reshaping the modern world.

As a result of these transitions, the aggregate level of trade between continental European countries today is astounding. Due to their geographical proximity, individual countries of Western Europe are able to maintain multiple trading partners at little or no cost. In 1996 exports of goods and services accounted for nearly half of Swiss real GDP even though it was the last year of a prolonged cyclical economic stagnation in Switzerland. An astonishing 62 percent of merchandise exports were sold to EU member countries alone. Currently two-thirds of Swiss goods are destined for the European Union while 75 percent of Swiss imports are derived from it. Furthermore, Switzerland has become the second largest trading partner of the European Union. Only the United States and Japan supply more goods and services to the EU, and only the United States imports more than the Swiss. ("Switzerland's Relations...")

EU members Germany, France, and Italy, all of whom share borders with Switzerland, are the main recipients of Swiss goods. (Merrill Lynch, p. 2) It is an undeniable fact that because of these geographic and historical ties, because Switzerland is such an integral component of both the European trade market and its associated commercial trade routes over and beneath the impeding Alps, and also because of the current global economic and technological consolidation, a stable external value of the Swiss franc relative to the euro is essential for a healthy, functional Swiss economy. (Merrill Lynch, p. 2)

Monetary policy provides the primary means by which the Swiss can leverage any control over the appreciation or depreciation of their currency. If that control is lost, as in the case from August 1992 to September 1995 when the Swiss franc appreciated 28 percent against the currencies of Switzerland's major trading partners, the entire Swiss economy suffers. (Merrill Lynch, p. 2) The adverse effects of this specific overvaluation contributed largely to a six-year stint of economic stagnation in Switzerland. In 1997, however, an export-led recovery was launched at the hands of a real effective depreciation of the Swiss franc and a proliferation in demand from neighboring European countries. A shift to an expansionary monetary policy was largely responsible for initiating the recovery. ("IMF Concludes...," p. 1)

Historically, appreciation pressures on the Swiss franc have been tied to the investment community's conception of Switzerland as a "safe haven." (Organization for Economic...," p. 38) A more extreme yet similar case of overvaluation occurred during the fall months of 1977 when international demand for the Swiss franc grew to such proportions that the Swiss National Bank was compelled to provide negative interest rates on Swiss franc deposits owned by foreigners. (Gehrig, p. 4) In both cases of appreciation, however, external circumstances in the European Community — specifically, an unstable exchange rate triggered by high external inflation — was the antecedent to the Swiss franc overvaluation.

These historical fluctuations represent the primary concern for contemporary policymakers. Uncertainties over the inception and pursuing infancy of the euro could bring about a capital flight from investments within the European Union to assets controlled by other hard currencies like the Swiss franc. An appreciation of the Swiss franc real exchange rate would follow, affecting both domestic output and employment in Switzerland. (Laxton and Prasad, p. 3) However, the possibility of such a preference shift in the direction of Swiss franc-denominated assets is speculative; furthermore, the effects of any such capital shift on the exchange rate and the Swiss economy are not entirely ungovernable. (Laxton and Prasad, p. 4) Through their monetary policy decisions, Swiss policymakers have the capability of adjusting their relevant monetary instruments in accordance with the present state of both internal and external economic conditions, the capital goal being price stability.

Present Know-How: The SNB and the ECB

As of the turn of the millennium, Switzerland faces a drastically different monetary situation. There are no longer multiple neighbors against which to gauge its monetary policies. Rather, Switzerland has become utterly engulfed by the single economic entity of "Euroland." (Gehrig, p. 2) The relationship between the EU and the smaller Swiss Confederation can be likened to that of a susceptible David and a volatile Goliath. Switzerland must bank on its sense to survive. It cannot assume a monetary policy stance opposed to that of the European Central Bank or it would be crushed beneath the weight of the ever-increasing and unpredictable European Union. The following comparison between the monetary policies of both parties will highlight their similarities, differences, and most significantly, the emerging dependency of David on Goliath.

Swiss Monetary Policy

Price stability in the medium term is the primary goal of the Swiss National Bank, and it strives to achieve this by making full use of Switzerland's production capacity. Stable prices are mandatory for a functional and successful economy. An unanticipated expansion of the money supply would result in demand increases for goods and services, which would lead to higher prices. An insufficient supply of money would have the reverse effects of hindering production and lowering the price level. ("Principles...," p. 1) The SNB also aims to smooth cyclical fluctuations in economic activity by adjusting interest rates in accordance with economic capacity. Additionally, with regard to the uncertainties of EU success, the Swiss National Bank is prepared at every moment to react to severe shifts in the exchange rate and the demand for money. ("Principles...," p. 1)

When it appears that a certain economic indicator has a relatively stable relation to the goal of price stability, the SNB will utilize that indicator as an intermediate monetary policy target. Historically, Switzerland has used the monetary base (M1) as its primary monetary indicator. ("Principles...," p. 1) However, by the end of 1998, the level of the monetary base was up 4.4 percent from the previous year, greatly exceeding its medium-term target path. ("IMF Concludes...," p. 4) Therefore, in 1998 the SNB decided that M1 was no longer a dependable indicator because fluctuations in banknote circulation and sight deposits, the two components of the monetary base, were deemed unpredictable. ("Principles...," p. 1) Consequently, Directors of the IMF Executive Board urged the Swiss National Bank to explain its policy decisions as clearly as possible and to monitor trends in more reliable monetary aggregates including the exchange rate, the cyclical position of the Swiss economy, and, above all, M3. ("IMF Concludes...," p. 3)

The SNB is in agreement with these indicators as additional means by which to control inflation in the short term. However, it considers M3, which includes banknote circulation, sight and other transaction deposits of the nonbank public, plus savings and time deposits, to be the most reliable indicator for targeting within the medium and long term. In fact, the monetary policy decision-makers at the SNB have become particularly fond of this broad monetary indicator, the most inclusive monetary aggregate tallied by the National Bank, because of its long-term relationship to the price level. ("Principles...," p. 2)

In summary, the SNB believes that accurately interpreting the monetary base (M1) is no longer feasible due to the unpredictable nature of sight deposits in the arena of international financial instability. ("Monetary Policy Plans...," pp. 1–2) Additionally, the SNB cites as its reasoning this general but functional rule: An expansion in M3 is followed three years afterward by an increase in inflation. ("Principles...," p. 2) In essence, if inflation is measured by a more stable indicator and over a longer period of time, the rate of inflation will fluctuate less. It is not surprising, however, that Switzerland's only neighbor, the European Union, also favors a relatively broad monetary aggregate, M3 to be specific, as its primary indicator. ("Challenges for the Monetary...," p. 5)

Implementing Swiss Monetary Policy

The supply of Swiss francs, and hence money market rates and liquidity, is regulated by the SNB through financial transactions with Swiss commercial banks. Specifically, the commercial banks place sight deposits, which are daily deposits serving as required reserves, with the SNB. Adjusting the supply of these deposits allows the SNB to tailor interest rates according to its desired monetary policy. Interest rate adjustments eventually affect both banknote circulation and the less liquid monetary aggregates. However, the magnitude of the required sight deposits is relatively small in comparison to the general daily movement of Swiss francs in the open economy. As a supplement to the desired supply of liquidity, the SNB chooses to operate in the call money market by purchasing assets and simultaneously selling them forward, a process otherwise known as a repurchase agreement or a repo transaction. This arrangement is achieved when one participant sells his or her securities for cash and agrees to repurchase them in the future, but the essence of a repo transaction is more like a secured loan in which the securities serve as collateral. ("Principles...," p. 2) This monetary policy was only recently implemented in April 1998; and over the latter course of that year, repurchase agreements became the most exercised monetary instrument of the SNB, outstripping the former favorite monetary policy-controlling device of foreign exchange swaps, which also consist of a spot transaction and a forward transaction. A liquidity swap provides a simple example of a foreign exchange swap. The SNB purchases foreign exchange against Swiss francs from commercial banks for a short period of time. At the end of that period, the transaction is reversed at a rate agreed upon at the initiation of the contract. ("The Central Bank's...," p. 1) Such swaps employ time horizons between one and twelve months. ("Principles...," p. 2) Conversely, repurchase agreements can be employed in both short- and long-term decisions with the foremost objective of conducting liquidity. This type of transaction is considered less risky than foreign exchange swaps because the salable securities must meet certain liquidity requirements. ("The Central Bank's...," p. 1) Bruno Gehrig, member of the Governing Board of the SNB, also notes the quantitative advantages of repo transactions: "Instead of just three or four, we now deal with some twenty partners. Starting this summer [1999], our range of counterparties will include banks abroad, which underlines our willingness to operate as broadly as possible." (p. 5) Nonetheless, foreign exchange swaps against the euro are still implemented as one of the National Bank's three primary monetary operations, as are advances against securities. ("The Central Bank's...," p. 1) It is not impractical, however, to assume that a highly successful and stable euro would eventually return foreign exchange swaps to the current inconstant and transitory spotlight of Swiss monetary policy instrumentation.

Swiss Monetary Plans for the Future

In detailing its monetary policy plans for 1999, the Governing Board of the Swiss National Bank declared its intention to maintain a liberal policy in order to prolong Switzerland's maturing economic recovery. Concerns over the kickoff of the euro were resolved with the pledge: "The best contribution monetary policy can make is to guarantee price stability," ("Monetary Policy Plans...," p. 1) which, in the opinion of the SNB, could be accomplished with an annual inflation rate of 1–2 percent.

Ironically, the Swiss have also defined price stability as a social issue since, in their opinion, weaker members of the *community* are the most severely affected by inflation. ("Monetary Policy Plans...," p. 1) The irony of this statement lies in the vague reference to "members of the community," which could be understood as either citizens within Switzerland or Switzerland itself within the broader context of the European Economic *Community*. In any case, the governing board of the SNB guaranteed that it would pursue a monetary policy similar to that of the European Central Bank in regard to both goals and operational framework. ("Monetary Policy Plans...," p. 1) The aim of SNB is to preserve exchange rate stability and, at the same time, to prevent the weaker members of the community, Switzerland in particular, from any inflationary suffering.

As of December 1998, the Swiss had expected an optimistic 1.5 percent expansion of real gross domestic product for 1999. There were bleak hopes for the export sector due to external expectations of weak economic growth throughout continental Europe. However, domestic demand in Switzerland should continue to strengthen the economy. ("Monetary Policy Plans...," p. 1) Prospects for a persistently low rate of inflation and an adequate exchange rate abounded. With regard to the introduction of the euro, the National Bank expressed its appetence for a smooth transition, yet remained poised to offset the effects of an increased demand for Swiss francs in the event of any external economic turbulence — specifically, that which could arise from the monetary policy decisions of the European Central Bank. ("Monetary Policy Plans...," pp. 1–2)

The Development of the European Central Bank

The Treaty on European Union, also known as the Maastricht Treaty, was signed in 1992. The primary objective of the Union was the establishment of the European Economic and Monetary Union (EMU) in which all member states would eventually share a common currency called the euro. Sound monetary and fiscal positions were required of all countries to be included in the monetary union. By midyear of 1998, eleven of the fifteen countries that initially signed the treaty had satisfied the rigorous membership qualifications. ("Challenges...," p. 1) Meanwhile, the European Monetary Institute had begun framing the guidelines for the European System of Central Banks (ESCB) to be headed by the independent European Central Bank (ECB). Today, the underlying objective of the ECB is to maintain price stability through the regulation of monetary policy for the entire euro-fied Union, while almost all fiscal responsibilities are to be retained by each member's central bank. ("Challenges...," p. 2) However, Article 7 of the ESCB Statute of the Maastricht Treaty guarantees a considerable degree of monetary policy independence for each respective country. Therefore, technically the ECB is left responsible for the "definition and pursuit of intermediate targets," M3 for example. ("Challenges...," p. 2)

On January 1, 1999, the euro was officially launched as the single currency of the eleven participating countries. Indeed, this event will be recorded in the annals of history as one of Europe's most challenging endeavors. The introduction of the euro required the most considerable relinquishment of sovereignty by members of the EU thus far. Moreover, every facet of European society was affected by the implications of the new currency, as were the economies of the European Union's major trading partners, among them, Switzerland. (Barbarinde, p.1)

Amid the tumult of the Kosovo crisis, its aftermath, and the Asian crisis, the inception of the euro was more successful than most analysts had predicted. However, various economists have noted a number of difficulties in ascertaining the ECB's monetary policy plans. Many criticize the lack of transparency, or policy privacy, in the European Central Bank's strategy, while others cite the Bundesbank of Germany and the Federal Reserve Board of the United States as two exemplary central banks that have succeeded somewhat in secrecy. (Mayer, "The ECB's...," p. S.07) Nevertheless, with examples of policy implementations from 1999, it is possible to piece together the opaque monetary policy framework of the ECB.

ECB Monetary Policy

The ECB faces contemporary challenges that other successful central banks have already overcome. Simply put, the ECB has no track record against which to gauge its performance. The effect of this, coupled with the magnitude of unification itself, has ushered in a potentially debilitating sense of risk associated with European financial markets and economies. Considering these uncertainties, the ECB maintains that in the end "money matters," and therefore has decided to pursue a long-term approach to price stability. It plans to accomplish this by analyzing risks to price stability, utilizing a broad set of indicators, and by targeting a reference value for the growth of M3. (Mayer, "The ECB's...," p. S.06) Clearly the decision makers at the ECB have acknowledged the several potential short-term implications of risk or, in this case, expected uncertainties; consequently, long-term stability is at the forefront of policy deliberation.

The ECB has openly defined the general framework of its policy plans, which consists of three primary objectives. The first objective, common to all monetary policy strategies, is a low rate of inflation. By the standards of the Harmonized Index of Consumer Prices (HICP), the European index for inflation, the ECB strives for an annual inflation increase of below two percent. The second objective is the utilization of a broad quantitative reference for the money supply. Finally, applying M3 as this broad monetary indicator, the ECB states that it, too, has assumed a vigilant stance with regard to price developments, considering specifically the potential risks associated with price stability in the euro area. ("Challenges...," p. 5)

The specifics of this strategy are not well defined. However, the ECB does not adjust interest rates in order to maintain its inflation objective, unlike the Bank of England, which adjusts its interest rates in response to deviations from the money growth target. Rather, the ECB believes that the euro must develop over an extended time horizon and that direct manipulation of policy tools in order to affect money growth should be shunned. (Mayer, "The ECB's...," p. S.06)

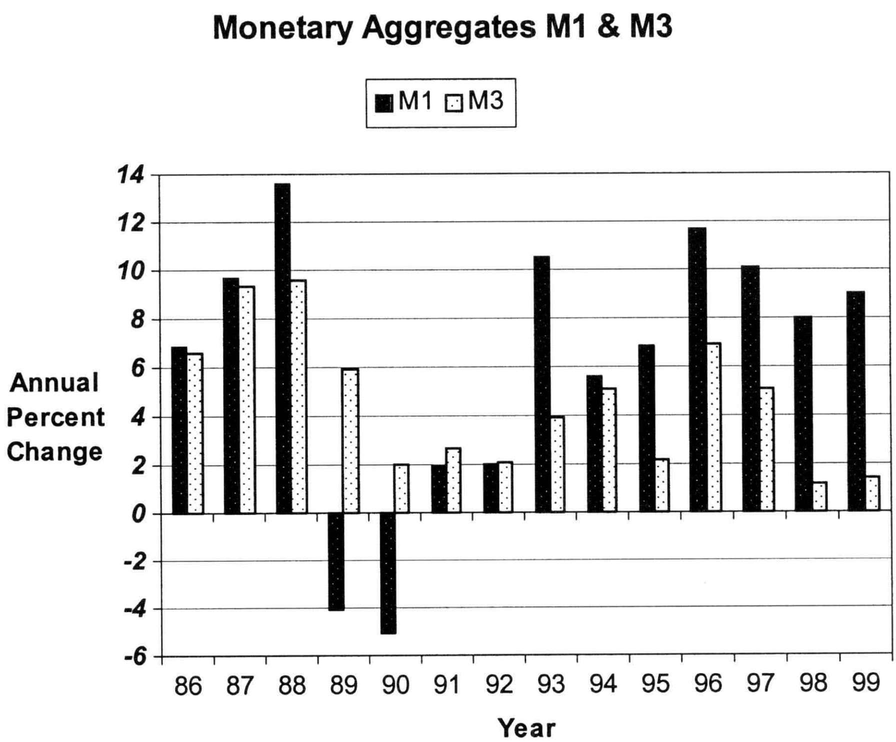
The non-transparency of its monetary policy strategy poses various challenges to investors in the European Union, its trade partners, and those of its neighbors who may be affected by its actions. Fortunately for the EU, because it has included or plans to include most of the European countries in its alliance, relatively few neighbors are left to be affected by decisions that are not their own. Unfortunately for Switzerland, because it is landlocked by EU countries and because it is not an EU member, the effects of the ECB's monetary policy flow through Switzerland as does the Rhine. So how do the Swiss protect their economy from a flood of francs that poses far greater devastation than the spring flooding of the Rhine River after a winter of the heaviest recorded snowfall accumulation in history?

The SNB Conforms to the ECB

Within the past two years, the Swiss National Bank has implemented a multitude of monetary policy changes in reaction to the European Central Bank's lack of transparency or clarity as well as its willingness to let the euro establish itself without severe monetary pressures. Because the euro has no track record, the ECB has elected to focus more aggressively on the medium and long term and is opposed to such short-term measures as the German and Swiss practice of inflationary targeting. This decision is founded upon the notion that the ECB must gain credibility in order to attract investors who are risk-averse.

Therefore, the ECB should take no risks with price stability in the short term because any deviation during that time would surely make it more difficult to achieve credibility in the long term. (Mayer, "EMU after...," p. 9)

Consequently, the behemoth European Union has relaxed its attention on the short term; and Switzerland, being susceptible to the implications of the monetary policy decisions inflation and therefore exchange rates are less likely to fluctuate dramatically between the two currencies. The following graph, which plots the change in percent of the Swiss monetary aggregates over the last four years, illustrates Switzerland's motive. Note the stability of M3 compared with M1, the former leading monetary aggregate on which the Swiss had set targets in order to predict and manage inflation.



Source: "Monetary Aggregates M1, M2, & M3"

of its only neighbor, has followed accordingly. In detailing the practices of both the ECB and the SNB, several apparent instances of monetary policy conformity by the Swiss are evident. Foremost is the Swiss National Bank's 1998 decision to monitor M3, the broadest of all monetary aggregates, as its primary indicator. The ECB utilizes M3 because it more adequately supplies information relative to the long term. Had the Swiss not adopted this new aggregate, exchange rate fluctuations would hinder future trade with countries of the European Union. With both the ECB and the SNB following M3,

The second step taken by the Swiss National Bank on the heels of the ECB is less obvious than the adoption of M3. In April 1998 the Swiss abandoned their primary monetary implementation tool of foreign exchange swaps and adopted repo transactions in its place. The SNB had formerly conducted exchange swaps against the dollar until 1997, against the D-mark of Germany through 1998, and against the euro since 1999. ("The Central Bank's...," p. 1) Throughout these years, however, the global economy suffered from a far-reaching stagnation as a result of the Asian crisis.

Perhaps the variability of its exchange swap partners over the last three years reveals the extent of the SNB's risk aversion. More likely, because repo transactions can be tailored for both the short- *and* long-term steering of liquidity, whereas foreign exchange swaps generally operate within a short time horizon, the Swiss have conveniently advanced yet another step in the direction of ECB long-term conformity. ("The Central Bank's...," p. 1)

Furthermore, in the December 4, 1999, quarterly bulletin of the Swiss National Bank, the Board of Governors announced that it will no longer practice money supply targeting, which had hitherto comprised the SNB's primary monetary policy. ("Quarterly...") The stage for this conversion was set upon the adoption of M3 in 1998 as the primary monetary aggregate. It was unclear at the time whether the Swiss planned to target the larger aggregate. However, the SNB later decided that, in agreement with the European Central Bank, M3 would be used as an indicator only. In the future, the Swiss National Bank will provide a three-year forecast, not a target, at the end of each year, and therefore has emphasized its need to adopt a long-term stance. ("Monetary Policy Decisions...," p. 1)

Finally, of less significance to the issue of ECB conformity, the Swiss National Bank slightly adjusted the semantics of its statement on price stability. In its monetary policy plans for 1999, the Governing Board considered price stability to be attained with an annual inflation rate of 1–2 percent. ("Monetary Policy Plans...," p. 1) However, in its proposed policy decisions for 2000, the Governing Board stated the same price stability consideration as the ECB, "less than two percent per annum." ("Monetary Policy Decisions...," p. 1) Although this instance of conformity appears insignificant, the decision made by the SNB to relinquish the range of 1–2 percent and adopt an upper limit only suggests that the Swiss have acknowledged the likelihood of a slightly more volatile inflation rate in the years to come.

Future Prospects: The Interest Rate Sling

Historically, the Swiss have not only survived but have flourished as a neutral country. Aside from maintaining neutrality, which serves primarily as a label within the broader context of current technological and economic globalization, the Swiss have preserved command over their primary monetary tool, interest rates. A recent decision by the Governing Board at the SNB highlights this sacred independence. On February 3, 2000, the target *range* for the 3-month LIBOR rate for Swiss francs, the most common money market rate for Swiss currency, was increased by half of a percentage point from 1.25–2.25 percent to 1.75–2.75 percent. This decision was based upon an alarming trend of a weak Swiss franc against the U.S. dollar, which threatened price stability. ("Increase in...")

Moreover, this instance attests to the order *still* maintained by the Swiss over their own house. In the case of any euro-related appreciation or depreciation of the Swiss franc, the SNB has maintained the power to tailor its interest rates accordingly. Retaining this right is of vital importance because the Swiss National Bank has historically supplied the lowest interest rates throughout all of Europe. If Switzerland ever decided to join the European Union, its interest rates would be required to rise towards the European Monetary Union average. (Déo and Gudin, p. 17)

In summary, after adopting M3 as its primary monetary aggregate and realizing it is too broadly defined for targeting purposes, the Swiss National Bank decided to target the interest rate level in the money market instead of the amount of liquidity, or M1. (Monetary Policy Decisions...," p. 3) The SNB believes that this new targeting or "steering" process provides greater transparency than the former practice (or vain endeavor) of steering M1, the most liquid of the monetary aggregates. At the same time, maneuverability is retained, and the central motive behind the Swiss anti-eurofication effort reveals itself: the Swiss can maintain their sacred neutrality and their low interest rates by conforming to, but not officially adopting, the general framework and long-term goals of the European Central Bank's monetary policy.

Conclusion

According to the Bible, when David confronted Goliath, he survived because he relied on his intellect as well as on the precise calculation of his sling. As of the turn of the second millennium, the Swiss have found themselves in the shadows of an equally treacherous situation, face to face with a modern giant called the European Union. Although the EU was launched with skepticism, its prospects for success eventually overcame the uncertainties that had plagued its inception while the Swiss, landlocked by EU member countries, opted for independence. Meanwhile, many speculators forecasted the inevitable doom of the Swiss economy if it were to remain outside of the Union. These forecasts may have proven correct had the Swiss not covertly managed to adopt several policies of the European Central Bank.

There are, perhaps, a multitude of other Swiss policy decisions concerning ECB conformity that have escaped the scope of my analysis. Similarly, many economists may argue against the notion of ECB long-term conformity; but in either case the obvious cannot be ignored. Accordingly, Jean-Pierre Roth, Vice-Chairman of the Governing Board of the Swiss National Bank, recently commented, "In terms of economic policy, the growing international integration means that the short-term development of an economy can now be steered to an even lesser degree than in the past." (Roth) Moreover, in an earlier speech, Roth's supervisor, Hans Meyer, Chairman of the Governing Board of the SNB, declared that, with regard to international cooperation, "the demand made on any individual country is therefore first and foremost to keep its own house in order." (Meyer, "International...," p. 8) Over the last several centuries, which have witnessed two World Wars, various European wars, countless treaties, pacts, agreements, and the foundation of several international organizations, each with its own political and economic agendas, the Swiss have upheld their own house with prestige. Despite the formation of the European Union and, for that matter, any other convergence of international powers that lies ahead, the Swiss flag will forever and always import neutrality, even if it necessitates at times overt acts of conformity.

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